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# Great Undervalued Stocks

What constitutes "value" among stocks can depend on the investor. However, Consumers Digest tapped stock-analyst companies to give you our top value picks for 2017.

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*Age Fotostock*

The mantra of investing—"buy low, sell high"—starts with figuring out what "low" means. For one investor, low might be a beaten-down company for which the stock price is far from its glory days but can scale the peaks again. For others, it's a company that has solid numbers and is ready for liftoff.

As a result, a stock that appears to be undervalued to one value investor might turn off another one. The differences can mean that a top undervalued stock that's identified through the use of one strategy could land in the middle or the bottom of the pack when it's viewed through the use of a different strategy.

Consumers Digest set out to determine the best value stocks in 2017 by identifying different, respected researchers of the value-investing scene and cross-referencing the information that we obtained from those sources. We collected information from four such entities.

Validea bases its investment portfolios on the strategies that renowned investors devise. New Constructs combines forensic accounting with machine-learning technology to produce lists of the "most attractive" and "most dangerous" stocks every month. Quadrix measures about 100 variables in seven categories (value, momentum, quality, financial strength, forecast earnings, performance and volume) to create an overall score that helps the company to determine which stocks are worth buying. Morningstar ran an analysis for us that sized up which value stocks appeared in the most large-cap, mid-cap and small-cap value funds.

If a stock appeared on at least two of the four lists, we deemed it to be a finalist and then consulted individual stock analysts to get corroboration or a contradictory opinion. The following 10 stocks result from all of this work.

## AMERICAN AXLE & MANUFACTURING

**NYSE: AXL; Price: $15.66**

*Company value: $1.7 billion; dividend yield: 0.00 percent; profit growth: 6.0 percent*

In an age that's focused on high-tech manufacturing, it's no surprise that some investors believe that companies such as American Axle & Manufacturing, which makes automotive drivetrains and the traditional working elements of internal-combustion engines, are dinosaurs. It certainly is priced as though it will be extinct soon.

"The [recent] stock price implies a permanent 70 percent decline in profits, and while we agree that the business is changing, we have no reason to think their business will implode," says David Trainer, who is the president of New Constructs. "Instead, we think they are likely to be the last one standing, which means their business has the chance not just to avoid shrinking but to grow and take market share."

JP Morgan Chase recently suggested that investors should *overweight*, or have more shares, of American Axle in their portfolio, and analysts put a December 2017 price target of $23 per share on the stock. JP Morgan Chase's most recent analyst report on the stock notes that American Axle historically traded at a discount compared with other automotive stocks, but the report also says a recent acquisition could help the stock to achieve full value.

Still, as with many bargain-price stocks, buying now might feel as though you're dipping into the scratched-and-dented bin. The stock is more than 30 percent off its 5-year high, according to our research. With the stock having no dividend, investors aren't being paid to wait for a rebound, even though New Constructs models suggest that investors will be paid in the end.

The "no-growth" value of American Axle—the price that the stock should be worth if it simply maintains its revenue or profit levels—is roughly $48 per share. If the company achieves any growth, the price could shoot past that level.



## APPLE

**Nasdaq: AAPL; Price: $153.99**

*Company value: $803.0 billion; dividend yield: 1.50 percent; profit growth: 21.3 percent*

If you are a fan of Warren Buffett, Apple is your hot stock. The Oracle of Omaha is loading up on Apple stock. His Berkshire Hathaway investment company held at least 60 million shares in Apple as of its last annual 10-K filing (a comprehensive summary report of a company's performance that must be submitted annually to Securities and Exchange Commission).
Since then, Buffett more than doubled his stake. He told CNBC at the beginning of March 2017 that he held 133 million shares of the stock.

Unsurprisingly, Apple is the top stock in the "patient investor" strategy that Validea bases on Buffett's investment methods. However, Apple also gets high-enough scores by other value investors that it makes Validea's top 20 overall list. The patient-investor strategy seeks companies that have "long-term, predictable profitability and low debt"—as Apple does—while they trade at reasonable prices.

Apple management notably has been shareholder-friendly. In April 2017, it authorized another $50 billion to be returned to shareholders through a dividend increase, and it continued stock repurchases.

"Not only is [Apple] the cheapest stock in the S&P 500, in our opinion, but it also has better growth prospects than many of the consumer-staple and discretionary S&P stocks that trade at higher valuations," says Brian Frank, who manages the Frank Value Fund. Frank says he won't buy stocks unless they're at deep discounts, and he has loaded up on Apple. "The upside is more limited than it was last year below $100, but it clearly has a moat with the App Store ecosystem and plenty of net cash on the balance sheet. That makes it more protective on the downside."

## BEST BUY

**NYSE: BBY; Price: $51.75**

*Company value: $15.9 billion; dividend yield: 2.30 percent; profit growth: 3.0 percent*

Best Buy might be the surprise of the list. It doesn't look like the classic value pick. For example, the popularity of the stock with fund managers pushed its price well past what Morningstar analysts peg as being the fair value on the stock. Typically, that's the point when Morningstar suggests that you sell, but our methodology indicates that the stock has room to grow further.

Value-oriented money manager Trip Miller, who is a partner at Gullane Capital Partners, asks himself the same question about every stock that he considers: Can Amazon.com hurt it? Therefore, he wouldn't buy a retail stock, such as Best Buy.

Barry James of James Investment Research acknowledges the Amazon problem, but he says Best Buy, which has a well-known brand and high-traffic retail locations, has fended off Amazon thus far.

"They have a good [price-earnings ratio], and they have been buying back shares," James says. "Best Buy rates in the top 1 percent of the 8,000 stocks we follow, grading it by valuation, profitability, performance and yield.

"It may face competition, but they seem to be cleaning the floor with them now," James adds.

## DISCOVER FINANCIAL SERVICES

**NYSE: DFS; Price: $59.71**

*Company value: $22.7 billion; dividend yield: 2.01 percent; profit growth: 22.6 percent*

Discover Financial Services is described as being one of the consistently most profitable financial-services companies in the United States. Its return on capital is nearly 20 percent, which is impressive for a financial-services company.

Discover, which often is considered to be a "poor man's American Express," is in a highly competitive industry, which makes it difficult for companies to increase profits. That said, Discover has had "healthy loan growth and higher dollar volume," according to Morningstar's Jim Sinegal, and that should help the company to maintain its position.

Despite that, New Constructs' research shows that the recent market price implies that Discover's profit will decline by at least 30 percent annually. That implication misses its economic book value of nearly $100 per share, so if Discover's stock trades at a price that includes no growth, then it's a $98 stock. If it shows growth of 5 percent or 6 percent annually for the next 5 years, which our research shows is reasonable, then the stock could be headed to $120 per share.

In April 2017, when Discover stock traded in the low $60s, Jefferies Group initiated a buy with a target price of $82 per share. Its analysts noted that “Discover remains one of the most prudent actors in what has become an increasingly competitive credit-card industry, and we believe this strategy may reward patient investors over the long term.”

## LAM RESEARCH

**Nasdaq: LRCX; Price: $152.91**

*Company value: $24.7 billion; dividend yield: 1.00 percent; profit growth: 15.5 percent*

Lam Research is an interesting technology investment, because it makes semiconductor fabrication tools. In other words, Lam benefits from the ever-expanding desire for technology without having to come up with the next hot chip, product or application on its own.

In our search for Wall Street’s best bargains, however, Lam shows why investors have to be decisive and buy the bargains when they see them. Since Consumers Digest began this research, Lam’s share price rose by roughly 20 percent as of press time.

Thus, Lam’s stock price is above Morningstar’s fair-value estimate, but Trainer says Lam is priced as though the company’s growth will slow, which he considers to be unlikely. “They have grown real profits over the last 4–5 years at 40 to 50 percent,” Trainer says.

Charles Rotblut, who is the editor of AAII Journal, agrees with Trainer. He says the stock could gain 25 percent from its current levels, which would be another big move that would bring its price-earnings ratio close to its historical average. “It’s on the rise, yes,” Rotblut says, “but it has the potential to keep going for a while longer.”

## LINCOLN NATIONAL

**NYSE: LNC; Price: $65.50**

*Company value: $14.7 billion; dividend yield: 1.66 percent; profit growth: 8.9 percent*

Lincoln National is another example of a stock that slides through the selection criteria without anyone being particularly excited about it. Perhaps they should be.

Lincoln compares particularly well with its multi-insurance peers, according to experts. The stock’s price-earnings ratio of just over 10 and price–book (assets minus liabilities) ratio of 1 are well below the industry average, and the company has solid operating-profit margins.

“Insurance companies don’t get you too excited, but if you find the right ones at the right price, they can be consistent performers that can make you happy for a long time,” says Jay Kaplan of Royce Small-Cap Value Fund.

Brian Culpepper of James Investment Research says Lincoln fits that bill. “If I had to pick a life-insurance stock, it would be [Lincoln],” he tells Consumers Digest.

### McKESSON

**NYSE: MCK; Price: $159.00**

*Company value: $33.7 billion; dividend yield: 0.72 percent; profit growth: 1.2 percent*

McKesson, which is the nation’s largest pharmaceutical distributor based on revenue, gets a 100 percent score on Validea’s Greenblatt model, which looks for companies that have a high return on capital and earnings yields.

Morningstar gives the stock a four-star rating, which signifies that it’s an above-average value, and pegs its fair value at $200 per share.

However, pharmaceutical stocks have lagged the market as of late, and pressure from the government and consumer groups to slow the inflation rate on medication prices puts pressure on companies such as McKesson.

That’s the classic value-investor’s dream—the chance to buy something after its price tumbled.

“Health-care companies with any involvement in drugs and drug pricing are an anathema to investors,” says Bill Smead, who runs Smead Value Fund. “Therefore, history would argue that hunting for bargains in a hated group is the right path. Like [legendary investor] John Templeton said, ‘Buy at the point of maximum pessimism.’”

That strategy requires patience, which was urged by Wayne Thorp of American Association of Individual Investors, who says McKesson faces “some near-term uncertainty regarding the regulatory environment and what’s happening in D.C. Once that gets sorted out, people will give this sector a harder look, and they will find this is a company that is well-positioned from a competitive standpoint, undervalued and generating tremendous amounts of free cash flow.”

### ROSS STORES

**Nasdaq: ROST; Price: $62.02**

*Company value: $24.3 billion; dividend yield: 0.90 percent; profit growth: 8.7 percent*

Ross Stores is the bargain investor’s bargain shop. It operates Ross Dress for Less and dd’s Discounts, which have at least 1,300 locations across the United States.

Unlike many stocks that score well for popularity among fund managers, Ross hasn’t been bid up past what Morningstar considers to be its fair value. (At press time, it traded close to even with that level.)

More important, although money managers worry about how Amazon seems to kill retailers, they aren’t concerned that Ross will fall victim to that trap.

“I like Ross Stores,” says Henry To of CB Capital Partners. “It’s one of the few brick-and-mortar stocks with a very entrenched and effective supply chain that could emerge stronger from the ‘Amazon effect.’”

According to Validea, “Investors could expect an average return of 20.2 percent on [Ross Stores] stock for the next 10 years, based on the current fundamentals.”

## SYNCHRONY FINANCIAL

**NYSE: SYF; Price: $26.84**

*Company value: $21.8 billion; dividend yield: 1.90 percent; profit growth: 18.4 percent*

Although everyone who is tied to retail worries about the presence of Amazon, Synchrony Financial actually is in a position to benefit from the “Amazon effect.” Synchrony is the fifth-largest credit-card issuer in the United States and is the largest issuer of private-label credit cards.

“As retailers have become increasingly pressured by the likes of Amazon, it has encouraged merchants to pursue additional revenue streams while necessitating the collection of shopper data to offer tailored marketing programs,” says Colin Plunkett of Morningstar. Synchrony provides retailers with that data, which are collected through its private-label business.

Rich Moroney, who is the editor of the Dow Theory Forecasts and Upside newsletters, notes that Synchrony has contracted 99 percent of its credit-card revenue through at least 2019. That provides stability and consistency, Moroney says, and he adds that analysts expect Synchrony to deliver double-digit profit growth in 2017 and annually over the next 5 years.

Moroney also notes that Synchrony trades at an 11 percent discount to the median consumer-finance stock, which is a big reason why he has the stock on his “buy” and “long-term buy” lists.

## WABASH NATIONAL

**NYSE: WNC; Price: $21.61**

*Company value: $1.3 billion; dividend yield: 0.56 percent; profit growth: 6.5 percent*

Wabash National designs and makes semitrailers and liquid-transportation systems. It’s the quintessential U.S. business in an industry where no one sees customers hitting the brakes at any time soon.

In 2017, the company raised its earnings guidance sharply, which resulted in price pops for the stock, including a jump of at least 10 percent after the most recent quarterly earnings were announced. That jump happened almost immediately after our research identified the stock as a bargain, and this might have taken some of the luster off the underpricing.

The recent gains are even more impressive considering how well that the stock performed in the recent past. Our research showed an annualized average gain on the stock of nearly 26 percent annually over the past 5 years. Still, the stock gained 33 percent in 2016—finishing the year by reinstituting its dividend, which it had stopped paying in 2008—and it was up nearly 30 percent through May 2017.

Although you might expect that all of the good news pushed the stock out of bargain territory, Wabash National remains in the top 10 percent of stocks for James Investment Research.

“[Wabash] has some of the highest returns on capital and is extremely well-positioned within its sector,” adds Trainer of New Constructs. “We think cyclical tail winds will help the business continue to grow profits faster than its peers, but the stock market’s valuation implies a permanent 20 percent decline in profits.”

According to Trainer, if the stock never were to grow again, it still would be worth $26.18 per share because of its fundamentals and cash flow.

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